

Outlook On The: Buy Now, Pay Later Industry

September 2025



Summary

- The BNPL industry is a fast-growing alternative to traditional credit cards
- We believe that the BNPL industry is misunderstood due to its novel operating model
- This report outlines our outlook on the industry, its key players, and on the unique business model adopted by BNPL providers

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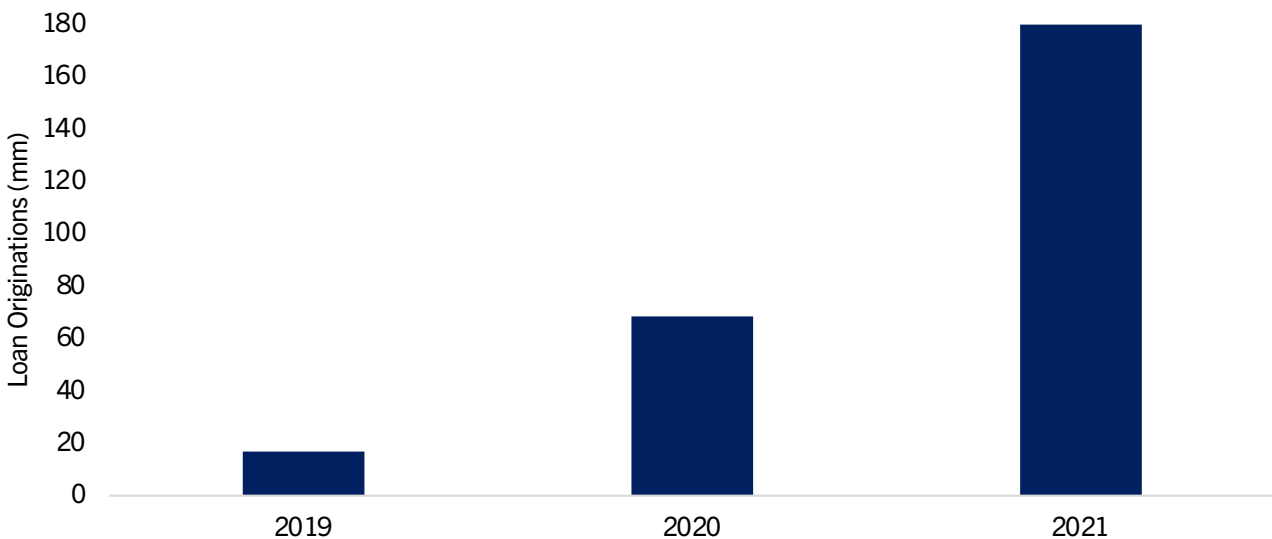
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Overview of the BNPL Business Model

Buy Now, Pay Later (“BNPL”) has emerged as a significant trend in the e-commerce industry. Its adoption surged during the COVID-19 pandemic as consumers increasingly turned to online shopping and sought flexible, low-cost payment options. The Consumer Financial Protection Bureau (“CFPB”) reported a remarkable tenfold increase in BNPL loans in the U.S., from 16.8mm in 2019 to 180mm in 2021 (Figure 1). Moreover, the dollar volume associated with BNPL loans surged from \$2bn to \$24.2bn over the same period (1). Globally, the BNPL market is projected to experience substantial growth, reaching an estimated \$560.1bn in 2025, indicating its rapid evolution from a niche fintech offering to an integral component of consumer finance (2).

Figure 1 Covid-Era BNPL Loan Origination Growth in the U.S.



BNPL is a short-term loan option that enables individuals to purchase items immediately and repay them over time, typically without accruing interest. The most prevalent arrangement is the “pay-in-four” model, where 25% of the total purchase is paid upfront, followed by three additional payments over a period of six weeks (3). Longer-term instalment plans are also available, with monthly payments ranging between three and 60 months, some of which may incur interest charges. These transactions are facilitated through user-friendly digital platforms seamlessly integrated into online checkout pages or mobile applications. This setup simplifies the shopping process and facilitates increased sales and larger order values for merchants (see Opportunities and Risks) (4).

TRANSACTION FLOW

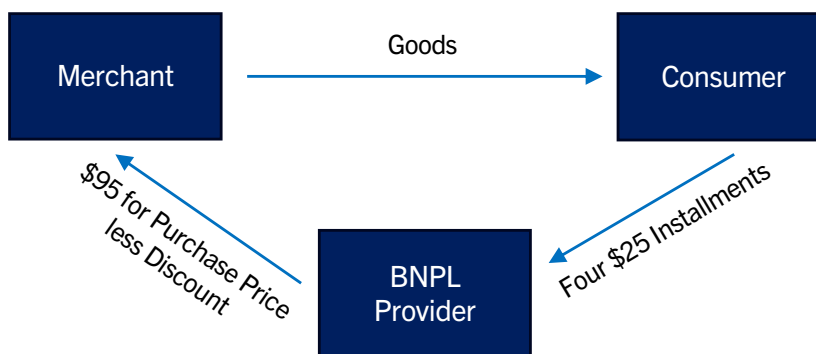
A BNPL transaction comprises three key entities: the consumer, the BNPL provider, and the merchant (Figure 2).

Consumer: The process commences when a customer opts for BNPL as their payment option during checkout, whether that be in-person or online.

BNPL Provider: The BNPL provider then instantly underwrites the transaction using proprietary algorithms and alternative data sources to assess consumer creditworthiness in real time. Algorithms often bypass traditional hard credit checks, utilising information provided by the customer such as age, email address, phone number validity, device data, basket size, and type of product to assess fraud and risk (5). Additionally, providers often perform soft credit checks utilising credit bureaus and open banking data. BNPL providers can tailor their risk assessments to each product individually, factoring in geography, item category, and basket size.

Merchant: Once approved, the BNPL provider pays the merchant the full purchase amount minus a transaction fee, thereby safeguarding the merchant from potential defaults and enabling immediate receipt of funds. Conversely, the customer gains immediate access to the product and assumes the responsibility of repaying the BNPL provider in instalments over a fixed schedule. Short-term plans typically do not incur interest charges, and certain providers have eliminated late payment fees altogether.

Figure 2 Sample \$100 BNPL Transaction w/5% Merchant Discount



REVENUE GENERATION

Merchant Fees and Pricing Strategies: The primary revenue source for BNPL providers is transaction fees charged to merchants for each purchase (6). Merchant discount rates (“MDRs”) typically range between 3% and 15% of the purchase price (7). MDRs tend to be higher than those associated with traditional credit card transactions, reflecting the value, increased sales, basket sizes, and customer conversion that BNPL brings to businesses (see Opportunities and Risks). Merchant mix plays a significant role in overall MDR yield: categories such as luxury goods, electronics, and travel often command higher fees due to stronger margins and lower default risk, while high-volume, lower-margin sectors like fast fashion and general merchandise typically negotiate lower MDRs (see Opportunities and Risks). Leading firms are increasingly experimenting with pricing models such as tiered pricing based on product category, basket size, and repayment terms. More effective pricing initiatives allow providers to protect margins while remaining competitive.

Interest Income: BNPL providers also offer longer-term financing options, suitable for larger purchases, with interest rates ranging from 0% to 36% APR (8). Companies such as Affirm generate substantial interest income from these loans, with lending-related revenues constituting 72% of Affirm’s revenue in Q3’25 (9). The market has increasingly

evolved its product mix toward higher-value, higher-margin purchases to boost revenue per transaction. While interest-bearing loans can be significantly more profitable than short-term interest-free plans, they also increase credit exposure and require greater balance sheet capacity, heightening funding and risk management demands.

BNPL Enabled Payment Cards: BNPL providers have expanded into the card sector, offering virtual and physical cards that enable customers to utilise BNPL with any merchant. When these cards are used, providers earn a card network fee. By backing out figures provided in Affirm’s 2021 S-1 filing, we estimate that Affirm’s virtual card revenue returned a yield of c.2% in FY24 (10). Although it remains an ancillary revenue stream, it represents an expanding segment of the BNPL business model, as providers introduce their own cards to the market.

Late Fees: Some BNPL providers charge late fees to customers who miss scheduled payments.

Subscription Revenue: Some BNPL providers generate revenue by offering a subscription service to customers, which allow customers to use BNPL at non-integrated merchants.

Servicing Income: BNPL providers use a mix of funding methods, including loan securitization and sales, to manage capital and reduce credit risk. Providers issue BNPL loans using funds provided by originators including banks, insurance providers, and other investors, aggregating numerous small loans into larger pools that they package into asset-backed securities. These securities are then sold to institutional investors (see Opportunities and Risks). BNPL providers retain loan servicing responsibilities for each pool of securitised loans purchased by 3rd party investors, recording servicing income from fees paid by 3rd party investors through the mechanism of a Service Agreement.

Gain (Loss) on Sale of Loans: The process of selling loans to institutional investors generates a gain on sale, if the loans is sold to the investors at a premium to the market value of the loan (sale price of the loan purchased from an originator less the market value of the loan). These loans are often sold at a loss on a cash basis, but are recorded as GAAP revenue. Take the example transaction in Figure 2. The BNPL provider funds a consumer loan for \$100 using funds from an originator. The market value of the loan is lower than \$100 - say \$93 - to reflect the present value of the stream of the loan’s future interest repayments. The BNPL provider will book the full \$100 loan and net it off by recording the \$7 discount as an expense (as long as the loan is not sold, this discount is then amortised over time and viewed as interest income). If the loan is sold to a 3rd party investor for say \$94, then the BNPL provider can book GAAP revenue of \$1 (\$94 minus \$93). In other words, the \$7 discount is released and offset by a \$6 loss. The BNPL provider has lost money on a cash basis but can record a gain on an accounting basis (11).

COSTS

Loss on Loan Purchase Commitments: In cases where a BNPL provider issues an interest free loan with funds from an originator, to create an economic incentive for said originator, the provider will often have to purchase the loan at a premium (par value) to market value (12). This results in a loss on loan purchase commitment. These losses

are correlated with the number of zero-interest rate loans issued by BNPL providers.

Credit Losses: In order to prevent the overstatement of assets, GAAP accounting rules require an allowance for credit losses to be provided for to reflect expected credit losses (13). Credit losses therefore represent the amount charged against income to maintain compliance with this requirement.

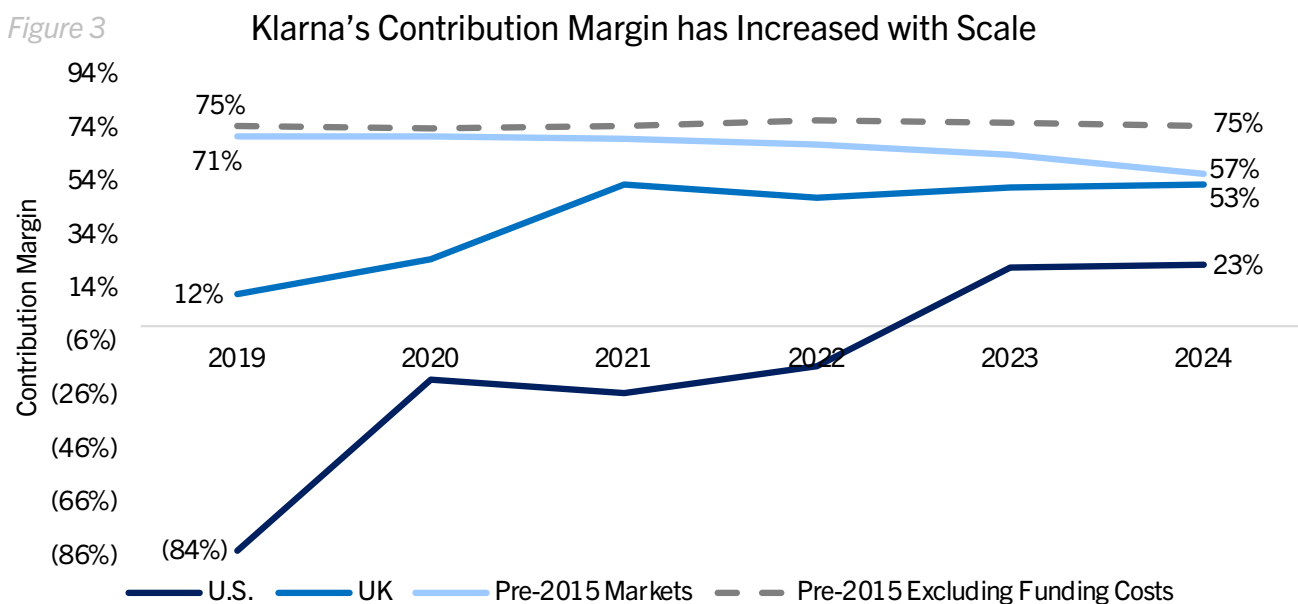
We believe that the growing concern about the increasing ‘provision for credit losses’ line-item reflects the markets poor understanding of how BNPL providers record revenue (see Opportunities and Risks)(14).

Funding Costs: Funding costs represents the interest expense that BNPL providers incur in order to access the capital markets and fund their loan issuances. This industry is heavily affected by macroeconomic conditions and the cost of capital, as such, funding costs are tied to the fed funds rate (15). Financing the cost of debt directly affects margins, and in a competitive market, providers face limited ability to raise customer APRs or merchant fees (see Opportunities and Risks).

Technology, Data, and Analytics: BNPL providers operate as technology-first financial platforms, with a significant portion of their cost structure tied to developing complex digital infrastructure. Proprietary underwriting algorithms, real-time risk assessment systems, fraud detection tools, and seamless integration with merchant checkout systems all require substantial ongoing investment. These core technologies are essential for managing credit risk, approving transactions instantly, and scaling efficiently.

KEY PERFORMANCE INDICATORS

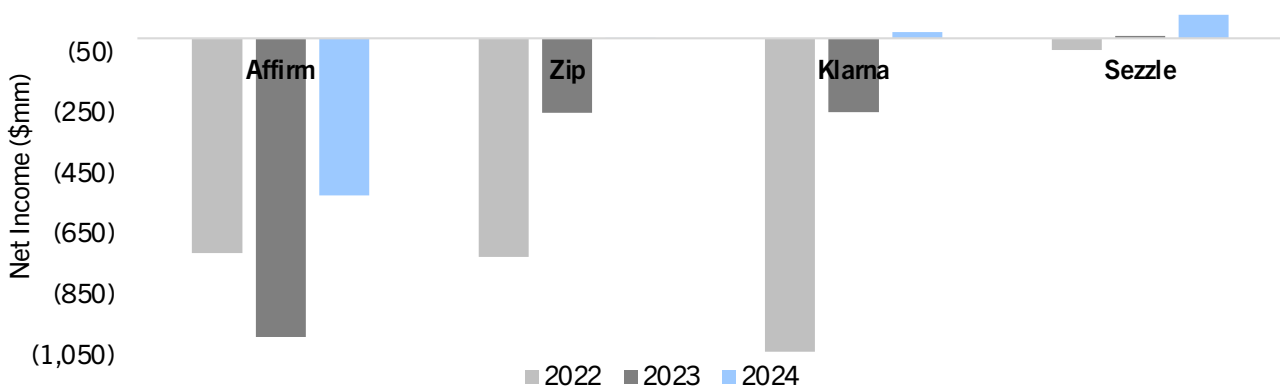
Contribution Margin: Contribution margin is an indicator of unit profitability and can be used to assess how scalable the BNPL business model is. It indicates how much revenue an individual loan generates for a BNPL provider once all associated transaction costs are removed. Klarna’s unit economics become relatively attractive as market position and cohorts mature (Figure 3).



Klarna’s unit margins have remained stable in their pre-2015 markets (EEA countries) and would have remained completely flat if not for interest rates driving funding costs higher. Klarna’s U.S. business began operating in 2019 and has improved its unit economics over time as the firm’s lending business has scaled. The same is true for Klarna’s UK business (16).

BNPL providers with positive unit economics should eventually turn profitable as fixed costs remain flat relative to the increasing number of loans being issued with positive unit economics driven by stable contribution margins (Figure 4).

Figure 4 Net Income/Loss for BNPL Providers



Overview of the BNPL Industry

MARKET SIZING

We can estimate the BNPL industry’s Total Addressable Market (“TAM”) by using the total payments and e-commerce markets as a guide (Figure 5).

Total Payments: The U.S. total payments market was estimated to house \$12.9tn in transaction volume in FY24 (17).

E-Commerce: The U.S. e-commerce market accounts for c.16% of total payment volumes. This implies a market size of c.\$2.1tn (18).

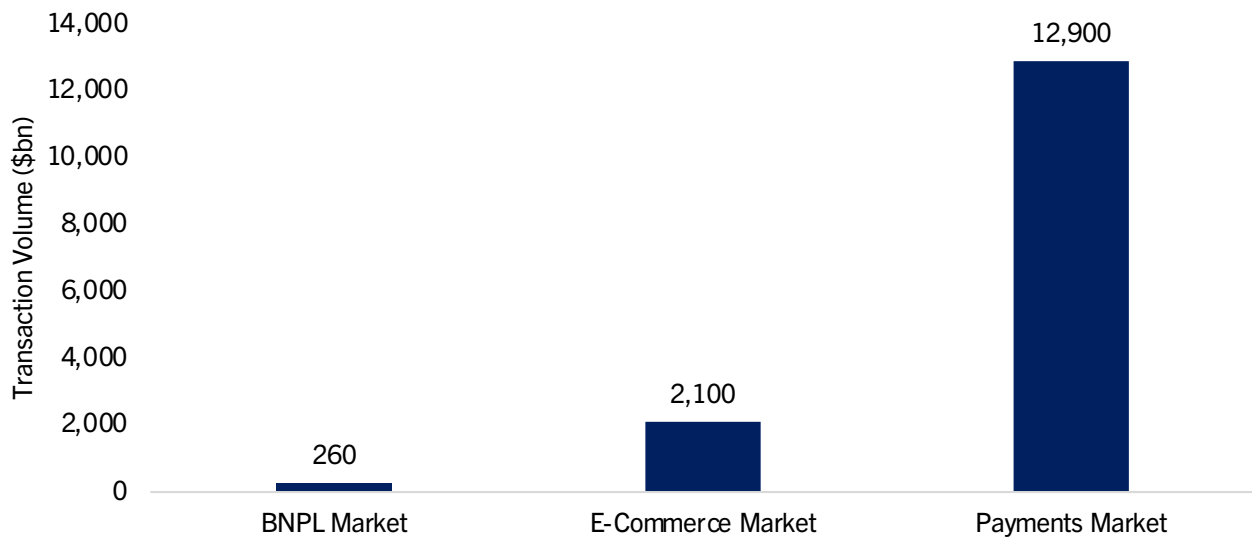
BNPL: In FY24, the U.S. BNPL market handled c.\$260bn of transaction volume, or c.2% of the U.S.’s total payment volume (19). These figures, although U.S. focused, provide a rough sense of the global BNPL industry’s size relative to the e-commerce and total payments markets. The BNPL industry is in its infancy from an adoption perspective. Its overall penetration rate is low in absolute terms, but we believe that this will change rapidly over the coming years. Transaction volume will drive this. BNPL players are growing transaction volumes c.2-3x faster than their credit card competitors (20). While Visa and Mastercard grew YoY transaction volumes by 8-9% respectively per their most recent quarterly filings, Affirm and Zip grew volumes by 36-38% over the same period (21).

BNPL integration with online retailers is one way to increase TAM penetration. For example, Affirm have integrated their BNPL products into Amazon’s and Shopify’s online retail ecosystem. This gives Affirm exposure to c.75% of the U.S. e-commerce market by

GMV (22).

Figure 5

BNPL Total Addressable Market



GEOGRAPHIC ADOPTION

BNPL penetration rates differ across geographies (Figure 6). We believe that this is driven by competitive dynamics in the credit card industry and BNPL’s relative maturity in different markets.

Australia: BNPL penetration is high in Australia (c.15%). Pioneers such as Afterpay launched in 2014 and became mainstream before banks and credit card networks began offering competitive instalment options. The regulatory environment, until recently, allowed BNPL providers to operate outside of traditional credit rules. This allowed for BNPL providers to scale rapidly through aggressive consumer marketing. Combined, these factors have made BNPL products a standard payment choice across a range of retail categories in Australia.

The United States: Penetration rates in the U.S remain low (c.5%) due to a strong credit card ecosystem. Lucrative rewards programmes and instalment plans reduce the appeal of BNPL. Rewards like cashback, airline miles and hotel points, not only offset interest costs but also create loyalty that BNPL providers struggle to replicate.

Europe: BNPL products are firmly established in northern Europe. Sweden and Finland are home to BNPL giant Klarna and report double digit shares of online transactions via BNPL. Germany, the UK, and the Netherlands are other key markets with fast BNPL growth. This has been propelled by fintech providers and traditional banks introducing BNPL payment offerings.

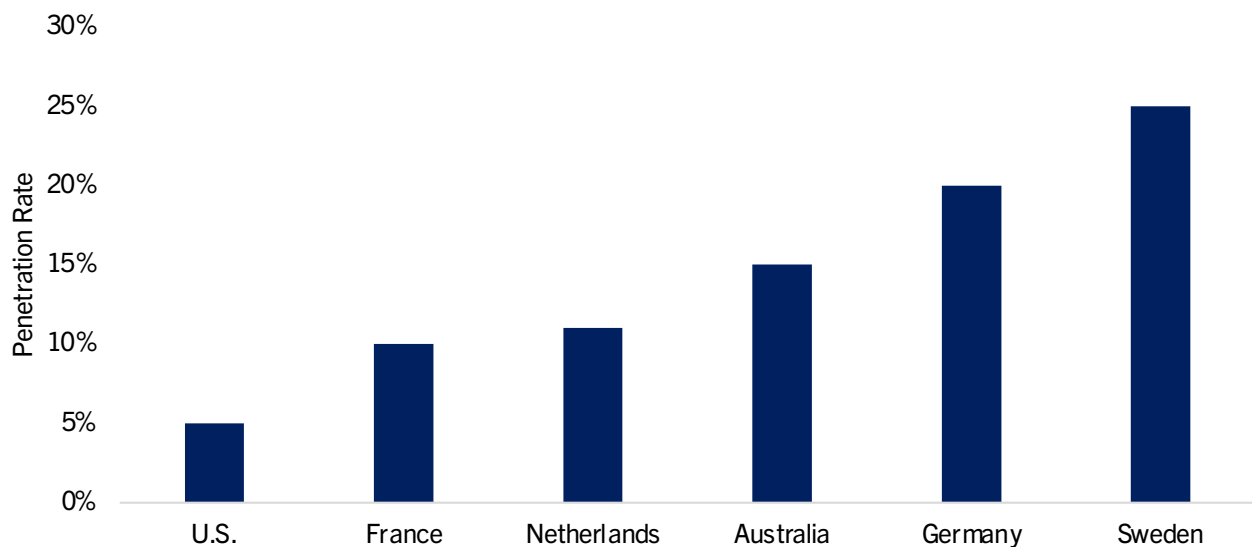
In the U.S., high interchange fees makes credit card acceptance expensive. These fees fund robust reward programmes. In Europe, regulation has ensured that card acceptance is cheap (23). Article 4 of the European Commission’s Regulation 2015/751 capped credit card interchange fees at 0.3% for all transactions occurring between EEA cardholders (24). In 2019 the Commission fined Mastercard €570mm, ruling that the higher fees applied to payments made in the EEA with consumer debt and credit cards

issued outside of the EEA (“inter-regional interchange fees”) were anti-competitive (25). Later that year the Commission extended the 2015 Regulations to inter-regional interchange fees and capped interchange fees to 1.5% for online credit card transactions (26).

At these levels, it is uneconomical for credit card providers to give a portion of their fee to customers in the form of rewards. This has made rewards programmes less common and less lucrative for customers. This reduces the opportunity cost of shifting spending away from credit cards toward BNPL products.

In places like Sweden, the Netherlands, and Germany, consumers are also more accustomed to direct debit and invoice-based payments rather than revolving credit. BNPL feels like a natural extension of existing habits rather than a replacement. These factors combined, position Europe for continued BNPL penetration.

Figure 6 BNPL Penetration as a % E-Commerce Transaction Value by Geography



CREDIT AND DEBIT CARD USAGE TRENDS

Debit and credit cards accounted for c.67% of total U.S. transaction value in FY24 (27). Debit/credit usage differs by demographic, with younger consumers - particularly Gen Z - exhibiting a preference for debit or alternative payment options over traditional credit (28). 35% of individuals aged between 18-29 in the U.S. did not own a credit card in FY24 (29).

USER CHARACTERISTICS

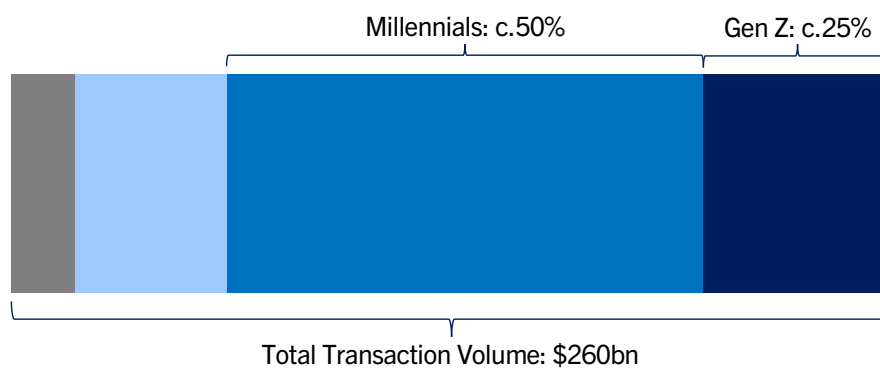
Age: BNPL usage skews towards younger consumers. 78% of Sezzle’s users are Gen Z’s and Millennials (30) and Bank of America report that c.70% of total BNPL usage comes from these two cohorts (31).

Income: Data surrounding BNPL usage by income bracket is inconclusive. Bank of America report that c.50% of households using BNPL products earn under \$50,000/year (32). Meanwhile, Morgan Stanley report that wealthier individuals are the most likely to make use of BNPL products (33).

Credit Scores: Data from the New York FED indicates that BNPL usage is significantly higher amongst subprime borrowers (see Opportunities and Risks)(34). However, it is important to recognise that individual BNPL providers can self-select (using credit scores and income as a guide) the users they are willing to lend to (see Key Players: Sezzle). For example, Affirm report that their average user has an income of \$74,000 and a near-prime credit score of 652 (35).

Common Purchases: High-margin retail goods are the mostly commonly purchased products. We have outlined why below (see Opportunities and Risks). These purchases include clothing, footwear, makeup, and electronics (36). Morgan Stanley report that grocery purchases also make up a significant portion of BNPL loans (37). We have outlined below why we see this as unsustainable (see Opportunities and Risks).

Figure 7 Gen Z and Millennials drive c.70% of BNPL Transaction Volume



REGULATION

Until recently, the BNPL industry in Australia, the UK, and the U.S. has operated in a light regulatory environment. This freedom has allowed providers to expand quickly. However, this is changing. In Australia, reforms are underway to bring BNPL under credit laws, thus requiring stronger affordability checks and hardship provisions. In the UK, the Financial Conduct Authority is set to introduce formal oversight, and in the U.S., the Consumer Financial Protection Bureau is becoming more active in monitoring BNPL practices. Over time the BNPL industry is likely to face stricter compliance requirements. This will bring the industry closer to the standards applied to credit cards and loans and is expected to improve protections for vulnerable consumers.

COMPETITION

BNPL providers compete for customers and merchant integration. Exclusivity deals (see Affirm’s Amazon and Shopify deals) are vital for providers, providing direct checkout integration. This has become increasingly important as merchant fees come under pressure, from more and more providers competing for the same integrations (see Opportunities and Risks). Pricing power may be retained by providers who can develop a payment eco-system that add value beyond online checkout pages (see Key Players: Block). This could include loyalty programmes or integrated shopping apps to create stickiness amongst their user base. In the long run, the industry is likely to consolidate around a handful of dominant players, with margins narrowing for those that cannot differentiate.

Key Players

PURE-PLAY BNPL PROVIDERS

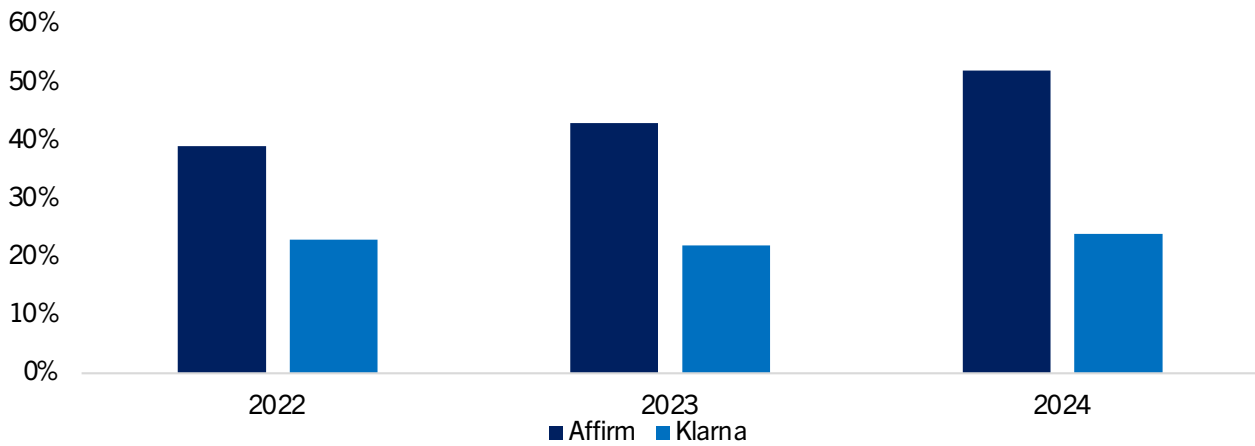
Klarna Group plc (NYSE: KLAR): Klarna, founded in Sweden in 2005, is the world's largest BNPL provider, serving 111mm active consumers and 794,000 retail partners. Klarna facilitated \$105bn of Gross Merchandise Value ("GMV") in FY24. The U.S. is Klarna's largest market, and it holds a dominant position in Europe and the UK as well (38). Klarna offers three BNPL products: Pay in Full, Pay Later, and Fair Financing. Between FY22-24, Pay Later accounted for c.75% of GMV. Pay Later is split into three products: (i) Pay in 30, this is the most common option where the consumer pays 30 days after purchase; (ii) Pay in 3, where instalments are paid every 30 days; and (iii) Pay in 4, where instalments are paid every 14 days. In 2024, 99% of transactions conducted on Klarna's network were interest-free and from FY22-24, Fair Financing has only accounted for c.4% of GMV. Klarna was valued at \$14.6bn in late 2024, a significant drop from the \$46bn valuation it earned in 2021 (39). Like many in the industry, Klarna's valuation is tied to the macroeconomic environment and the health of the consumer. Klarna filed for an IPO in March 2025, but the firm paused its plans following tariff announcements by President Donald Trump. The firm finally IPO'd in September 2025 (40).

Affirm Holdings, Inc. (NASDAQ: AFRM): Affirm, founded in 2012 by Max Levchin - a PayPal co-founder - is the largest BNPL provider in the U.S. Affirm serves 22mm active consumers and 358,000 retail partners. Affirm's recorded \$26.6bn of GMV in FY24. Affirm's partnership with Peloton in 2018 was key to its early success and rapid growth. Analyst estimates indicate that Peloton accounted for c.30% of revenue and GMV in FY20 (41). This allowed Affirm to earn a higher Average Order Value ("AOV") from customers financing expensive Peloton bikes. Affirm continues to distinguish itself from competitors by financing larger ticket items. In their latest quarterly filings Affirm reported an AOV almost 3x Klarna's (\$273 v \$100)(42). Management claim that their early experience underwriting big ticket purchases gives Affirm an underwriting advantage relative to their peers (43).

Affirm offers three BNPL products: 0% Monthly APR loans, Pay in X instalment loans, and interest bearing loans. Pay in X loans are identical to Klarna's Pay in 4 product, while 0% Monthly APR loans are just a longer term version of Pay in X. Unlike Klarna, Affirm generates the majority of its revenue from interest bearing loans. In FY24, 74% of loans originated were interest bearing, up from 58% in FY22. Interest income as a % of total revenue has increased from c.39% to c.52% over the same period (Figure 8). The remainder of Affirm's revenue comes from merchant fees, card network fees, servicing income, and gains on the sale of loans (44). The merchant fees Affirm collects from interest bearing loans are far lower than the fees charged for 0% instalment and Pay in X loans (1.5% vs 5-12.5%). This intuitively makes sense as Affirm's interest bearing loans function similarly to regular transactions with a credit card. Affirm's 0% APR instalment product earn the highest merchant fees to compensate for the risk of underwriting a longer term, non-interest bearing loan (45).

Figure 8

% Revenue from Interest Bearing Loans

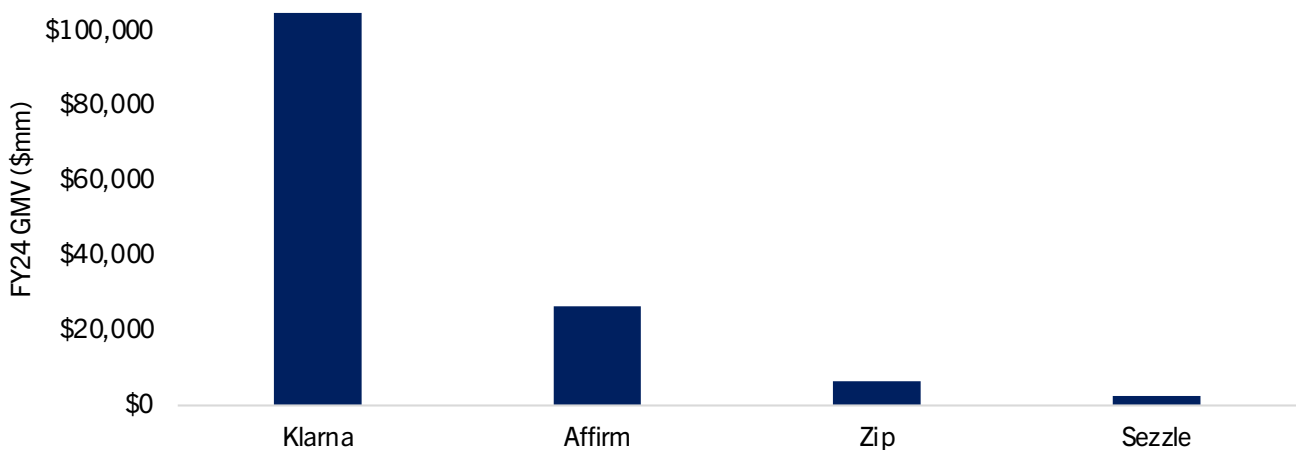


Zip Co Limited (ASX: ZIP): Zip was founded in Australia in 2013 and is the 2nd largest BNPL provider in the country behind Afterpay. The firm also operates in New Zealand, Canada, and the U.S. Zip serves 6.3mm active customers and 81,900 retail partners (46). The firm recorded c.\$6.5bn of GMV in FY24. Zip’s main offerings are Zip Pay, where consumers can choose between an interest free Pay in 4 and a Pay in 8 product for purchases up to \$1,000; and Zip Money, a long-term line of credit for purchases over \$1,000. This is similar to Affirm’s interest bearing loan product.

Sezzle Inc. (NASDAQ: SEZL): Sezzle was founded in the U.S. in 2016 and was listed on the Australian Securities Exchange in 2019 before moving to the NASDAQ via a direct listing in 2023. Sezzle has shut down operations in Europe, India, and Brazil and now focus exclusively on the U.S. and Canadian markets, their most profitable regions. Sezzle serves 2.7mm active consumers and 412,000 retail partners. In FY24 Sezzle recorded \$2.5bn of GMV. Sezzle offers five BNPL products: Pay in 2, Pay in 4, Pay in 5, Pay in Full, and a Long-Term product. Sezzle’s Long-Term product functions like Zip and Affirm’s long-term loans. These loans bear interest and the % APR charged depends primarily on the length and size of the loan (47). Sezzle have transitioned away from the high-growth strategy targeted by all the other pure-play BNPL providers. In 2022 the firm shut down operations outside of North America, reduced headcount by c.20%, and stopped underwriting loans to unprofitable consumers and merchants. A year later they turned profitable. Sezzle now operate with a c.30% Net Income margin. Klarna and Zip operate with Net Income margins below 1% while Affirm has yet to become profitable (48).

Figure 9

FY24 Gross Merchandise Value for Pure-Play BNPL Providers



INTEGRATED BNPL PROVIDERS

Block, Inc. (NYSE: XYZ): Block (previously Square) acquired Afterpay - Australia's largest BNPL provider - in 2021 for \$29bn, making it the largest buyout in Australian history. Afterpay was founded in 2014 and operates in Australia, New Zealand, the U.S., Canada, and Europe (under the name Clearpay). Afterpay's parent company, Block, owns Square, a point-of-sale platform for businesses; and Cash App, a mobile finance app serving 57mm users (49). Afterpay is integrated into both platforms. This drives more merchants to the Square platform, keen to benefit from the increased demand, conversion rates, and AOV associated with Afterpay's BNPL products. This also makes CashApp a more attractive product for consumers, as it provides a one-stop-shop for users to manage their finances. CashApp now offers Afterpay's interest-free Pay in 4 product and its long-term, interest-bearing loan product for larger purchases. At the time of acquisition Afterpay served 16.2mm consumers and 98,000 retail partners. Block have not provided updates to these figures, but since acquisition, Afterpay's revenue has doubled from \$693mm in FY21 to \$1.3bn in FY24 (50).

Since the Australian BNPL market is more mature than the U.S. market, developments in Australia serve as a useful guide for what a more mature U.S. market might look like. Before being acquired by Block, Afterpay reported that on average, their Australian customers completed 34 transactions a year (with the top 10% of Australians completing 64 transactions a year). Notably, the top 10% of U.S. consumers only completed 24 transactions (51). As the U.S. market matures, consumers should engage in an increasing number of BNPL transactions. Block no longer provides this breakdown, but this year, Affirm (U.S. based) reported that it generates 5.6x average annual transactions per active customer (See Opportunities and Risks)(52).

PayPal Holdings, Inc. (NASDAQ: PYPL): PayPal operate a two-sided network that connect consumers and merchants, with 434mm active users across 200 separate markets. In FY24 the company facilitated GMV of \$1.7tn (53). PayPal has the largest platform-agnostic installed based on all BNPL providers, 3x larger than its closest competitor (54). During 2020, PayPal launched 'Pay Later', a BNPL service integrated into the broader PayPal ecosystem at no incremental cost to merchants. Within a quarter, PayPal's BNPL service had facilitated \$750mm of GMV and connected 2.8mm consumers with 250,000 retail partners. Pay Later provides four product options to consumers: Pay in Four, Pay in Three, Pay Monthly, and Pay Over Time. The company does not provide a break down of revenue split between these products.

Figure 10

FY24 KPIs for the Pure-Play BNPL Providers

(in millions)	Klarna	Affirm	Zip	Sezzle
Revenue	\$2,811	\$2,323	\$563	\$271
Net Income	\$21	(\$517.8)	\$3.7	\$78.5
Active Users	111	22	6.3	2.7
Merchants	.794	.358	.082	.412

Opportunities and Risks

OPPORTUNITIES

Structured Finance is a Tailwind: Securitisation is a tailwind for the BNPL industry. Unlike banks, most BNPL providers do not finance loans via deposits. Instead, they rely on external funding. Securitisation allows asset-light BNPL providers to scale rapidly by facilitating access to capital. It allows providers to achieve a lower cost of funding while also removing securitised assets from their balance sheet, enabling providers to effectively manage their equity capital (55;56). It also offers an attractive fixed-income product to investors willing to bear some risk. In 2024, Elliot Advisors purchased a \$39bn loan portfolio from Klarna’s British business and in 2023 KKR purchased \$44bn of BNPL debt from PayPal (57).

The securitisation of loans is nothing new to the financial world. Asset-backed securities are often created for a variety of debt instruments, including student, auto, and credit card loans. Bundling BNPL loans into a financial instrument which can be sold to investors is no different (58).

Several structured products are available to BNPL providers who wish to issue and finance their BNPL loans. Warehouse facilities are used when originating loans directly or purchasing loans from an originating bank (59). Warehouse facilities are structured so that the beneficial title to a pool of assets is transferred to a Special Purpose Vehicle (“SPV”). This is an ‘on balance sheet’ structured product, as the BNPL provider is deemed to have control over the SPV for accounting purposes. To offload this risk, the BNPL provider will then engage in either a traditional Asset-Backed Securitisation (“ABS”) or a Forward Flow Agreement (60).

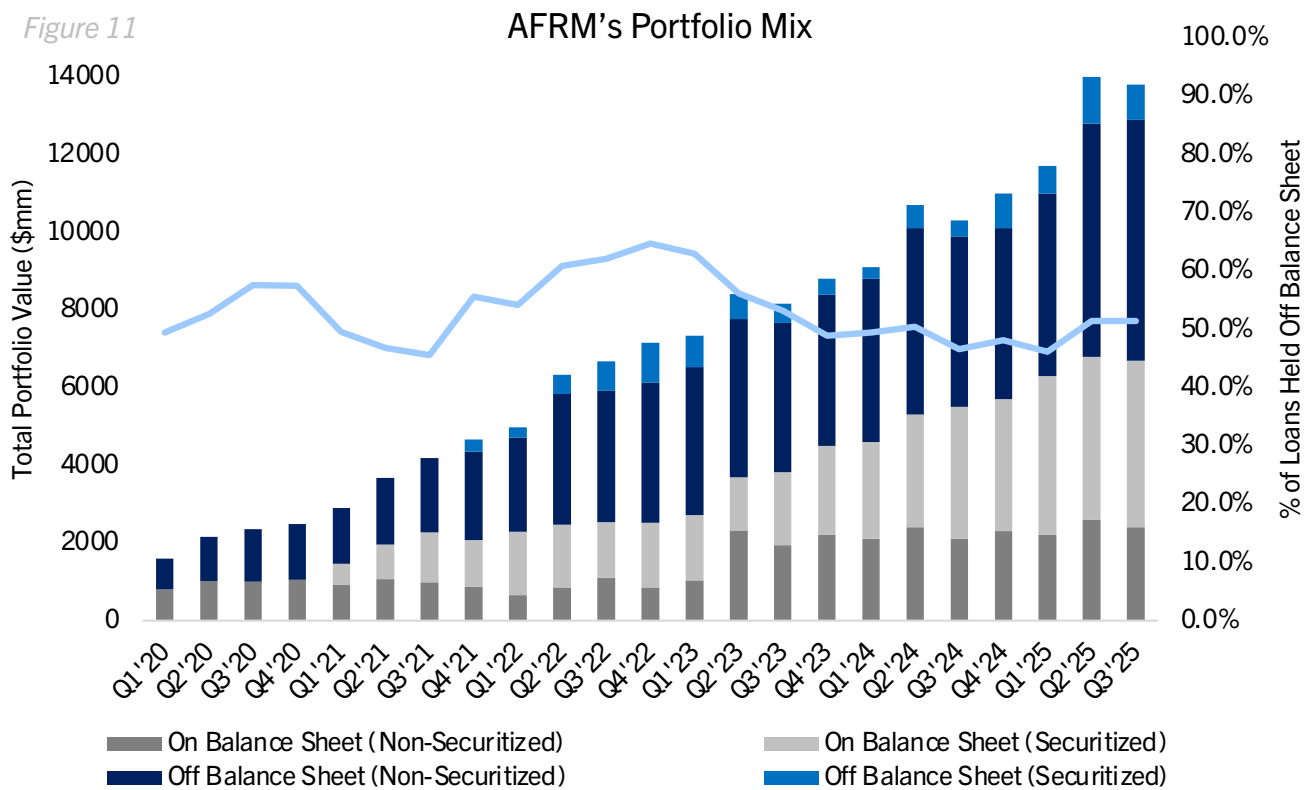
In an ABS transaction, the pool of assets in the SPV are held as security for the issuance of (asset-backed) debt. These securities are often structured with senior, junior, and potentially mezzanine tranches, each offering various levels of risk and return for investors (61). This reduces funding costs for providers while providing an attractive investment opportunity for lenders. If the ABS transaction is static, meaning that the pool of loans in the SPV is fixed, then the transaction will often receive ‘off balance sheet’ treatment. If the pool of loans in the SPV are constantly revolving, then the transaction will likely be considered ‘on balance sheet’, due to the amount of control the BNPL provider has over the SPV assets.

A Forward Flow Agreement usually receives ‘off balance sheet’ treatment. Here, an investor pre-funds the originated loans or the relevant SPV, as such, beneficial title in the assets transfer instantly to the investor upon origination. Because of this, the originated loans do not show up on the BNPL providers balance sheet (62).

BNPL providers have adopted different approaches to how they implement structured finance into their business models. Klarna have operated as a licenced bank in the EEA since 2017. This means that they can fund loans directly via consumer deposits. In 2024, Klarna originated 94% of its BNPL loans using deposits held on its balance sheet.

In 2024, only 10% of Klarna’s loans were held ‘off balance sheet’ through Forward Flow Agreements. To mitigate the risk associated with holding 90% of loans on their own balance sheet, c.15% of Klarna’s ‘on balance sheet’ loans have had their credit risk transferred to investors via synthetic securitisation. As with other forms of securitisation, synthetic securitisation involves the pooling of assets in an SPV. Here, Klarna transfers a portion of credit risk to an SPV. The SPV then issues credit-linked notes or guarantees to investors (63). Since Klarna retains contractual rights to the cashflows of the pooled-assets, these assets remain on Klarna’s balance-sheet (64).

Other players operate a more asset-light business model (figure 11): Affirm has historically held c.50% of its loans ‘off balance sheet’ through both Forward Flow Agreements and ABS transactions (65). To further mitigate against any credit risk, c.65% of Affirm’s ‘on balance’ sheet loans are securitised through a revolving ABS (66).

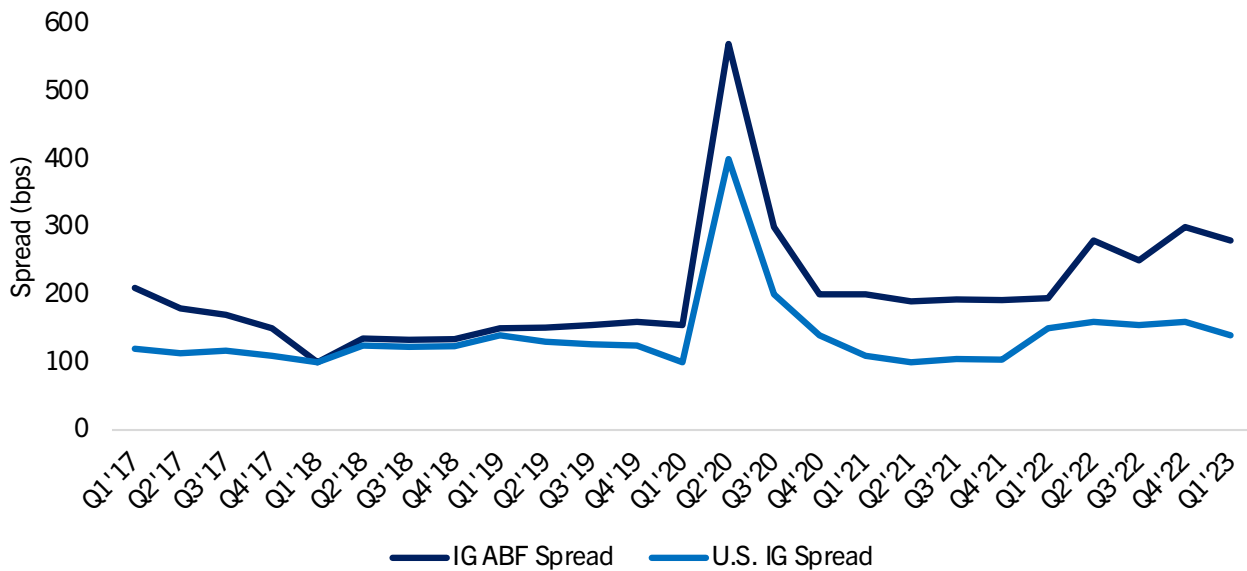


Structured finance also serves as a tailwind for institutional investors looking to earn equity-like returns in the BNPL debt market. Yields on the senior and mezzanine debt tranches of these products tend to return mid to high single digit returns (67) and the spread between U.S. investment grade asset-backed products and U.S. investment grade corporate bonds has historically been attractive (figure 12). Taking a step back, the creation of a discrete financial instrument for pooled BNPL loans that can be traded and priced by financially-motivated market participants, is likely to lead to a more efficient allocation of capital and a lower cost of funding for BNPL providers and consumers.

Increased Consumer Spending: As the BNPL industry grows, consumer spending

should grow with it as consumers are afforded greater freedom to finance short- and medium-term purchases such as furniture, technology, and groceries. The extent to which it is economical for merchants to provide BNPL options to consumers for certain products is discussed below. Nevertheless, the use of this form of payment is already widespread across developed economies: over a quarter of U.S. consumers have used BNPL loans to finance purchases (68). As the securitised market for BNPL loans grows, merchant adoption should rise with it, providing consumers with more choice.

Figure 12 Spread of U.S. Investment Grade ABF vs Investment Grade Corporate



Reduced Debt Burden: Thanks to financial engineering, BNPL providers have created a business model where it is profitable for them to offer zero interest loans to consumers. This in turn allows consumers to reduce their overall debt burden by financing purchases through a BNPL product, rather than through a traditional credit card.

Sales Growth for Merchants: Merchants also benefit from the growth of the BNPL industry. The economics for merchants are simple. By partnering with a BNPL provider, merchants can increase sales volume. BNPL providers provide a significant amount of information as to how their products boost customer sales conversion, order size, and purchase frequency. For example, Affirm have reported that their products increase average cart size by c.70% (69). In return for increased sales, merchants pay a higher fee to the BNPL provider than they would to the average credit card provider (2-6% v 1.5-3.5%) (70).

Even if the economics of an individual transaction are marginally less attractive through a BNPL provider than through a credit card provider, BNPL products still provide value as the merchant receives the entire purchase price of the good or service upfront, even if, in the case of a Pay-in-4 transaction, the customer has only paid a quarter of the purchase price. Upfront payment reduces receivable risk for the merchant and is more attractive than the payment processing system adopted by credit card providers, where merchants often wait two business days before a transaction is fully processed. Merchants also avoid the issue of dealing with chargebacks or returns.

Network Effects Should Aid Growth: The BNPL industry operates as a two-sided

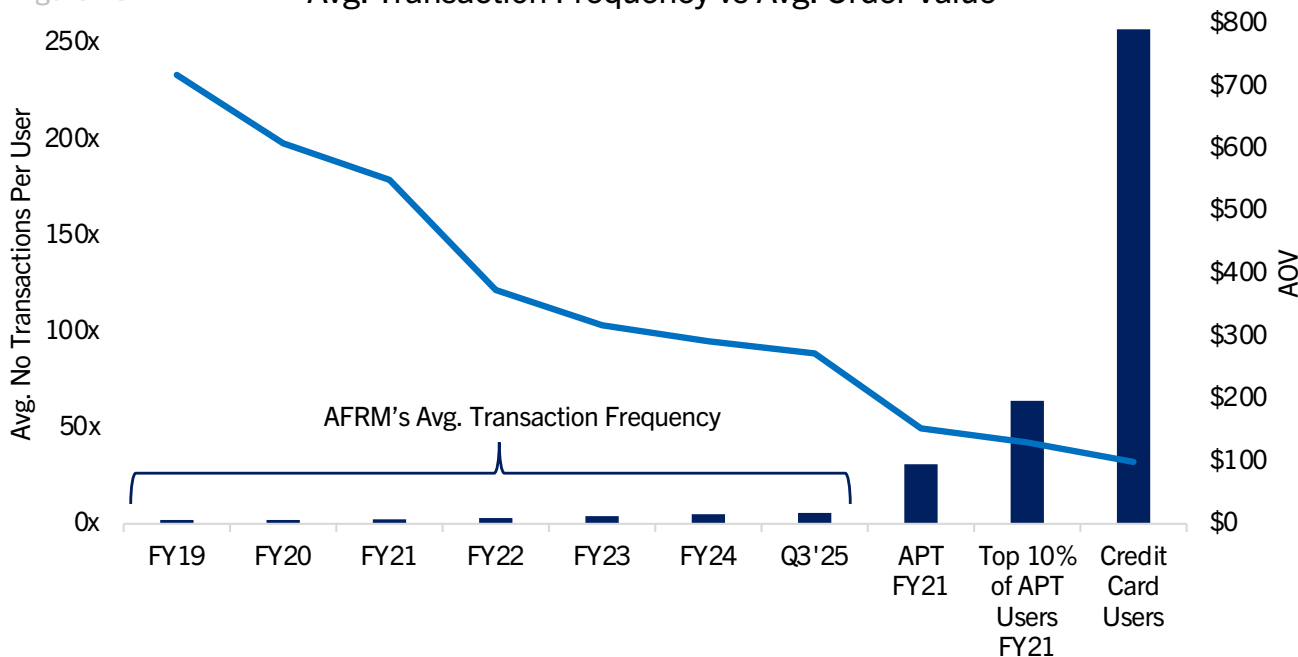
network. As such, it should benefit from traditional, reinforcing network effects. As more merchants join, more consumers will sign up, in turn encouraging more merchants to join again. This is a powerful flywheel which should allow the industry to continue to grow (71).

This growth can be measured through (a) transaction frequency; and (b) Average Order Value.

In its latest quarter, Affirm reported that the average active consumer completes 5.6x BNPL transactions a year, up from 2.0x in the same quarter of 2019, when Affirm first began providing transaction frequency data (72;73). This indicates that consumer engagement is increasing and that the flywheel is operating as expected. Before being acquired by Block, Inc., Afterpay - an Australian BNPL provider - reported that their latest cohort of Australian customers completed 31x transactions a year (74). Afterpay's success in the mature Australian market is a marker for what transaction frequency might look like in a more mature U.S. market and how a powerful two-sided network effect impacts consumer behaviour.

Sense-checking BNPL transaction frequency against credit card transaction frequency is also helpful. Capital One Research reveals that the average U.S. credit card holder completes 257x transactions per annum (75). Transaction frequency growth will be key metric to watch, as it should tell us the extent to which BNPL providers are taking market share from credit card competitors (Figure 13).

Figure 13 Avg. Transaction Frequency vs Avg. Order Value



Growth can also come from increasing AOV. However, AOV and transaction frequency appear to be inversely correlated. Affirm, with the lowest transaction frequency per active customer, has the highest AOV (76). Afterpay's AOV was c.\$150 (77) while the average credit card AOV is c.\$99 (78). We expect that as the BNPL industry grows, AOV's should decrease while transaction frequency increases (Figure 13). Below we have laid out why we think there is a theoretical limit to how much transaction frequency

can increase and how low AOV can go.

Democratisation of Credit: By underwriting each transaction individually, BNPL providers are able to differentiate themselves from their credit card competitors, who instead underwrite lines of credit. Increased granularity and dynamic risk assessments gives providers the ability to freeze or shut down delinquent accounts immediately. This provides flexibility for the BNPL providers to underwrite loans for consumers who would not - or otherwise could not - access credit from a traditional credit card provider. BNPL providers should be able to continue to grow by tailoring their product offering to different consumers depending on their perceived risk of default (79).

It is important to note that BNPL products are not just targeted towards consumers who are unable to finance purchases via a credit card. The optionality provided by BNPL allows consumers of all risk-profiles to pay on their own terms, better reflecting the inconsistent nature of consumer cash flows. BNPL provides the benefit of accrual accounting to consumers who otherwise operate in a cash accounting world (80).

RISKS

Credit Quality: 52% of Affirm's consumers are subprime borrowers (81) and in Q1'25, Klarna's net loss more than doubled, driven in part by a 17% YoY increase in customer credit losses (82). These factors have given rise to concerns about the credit quality of BNPL loans and the strength of BNPL consumers (83). Morgan Stanley's Asset-Backed Securities Team have highlighted similar concerns: "If BNPL usage were to grow rapidly later this year, when we expect consumers to be more stretched due to elevated inflation from tariffs and slow income growth, we would potentially take that as a warning sign" (84).

However, it should be noted that Klarna's delinquency rate as a % of total loans outstanding has actually decreased over time, falling 14bps from 1.03% to 0.84% YoY (85). Looking at credit losses alone is misleading, as Klarna books credit losses up front for each new loan issued and recognises revenue over time. Rising credit losses alone simply means that total loan issuance is increasing. Additionally, Affirm have announced that they will begin reporting transaction data with credit bureaus (86). This should result in a positive mix-shift towards consumers looking to improve their credit rating while also incentivising consumers who would not otherwise, to meet their payment obligations on time. It remains to be seen whether other BNPL providers will follow Affirm's lead.

Systematic Risk: Given the significant % of subprime loans which, based on available securitisation documentation, are packaged into ABS products, questions may arise as to potential default risk and the impact this may have on the broader ABS market. It is our view that the default risk associated with BNPL ABS products is not systemic.

The size of the BNPL industry limits systemic risk, even in the event of widespread defaults. The global BNPL market is only c.\$560bn (87), while U.S. card balances alone reach c.\$1.2trn (88).

Duration: This year, 30% of BNPL users have financed groceries or restaurant purchases with BNPL products (89). While this shows a more widespread adoption of

BNPL as a form of payment it could also signal potential risks. We highlighted above the growing trend towards lower AOV transactions. Financing grocery shopping and restaurant trips are examples of this. We think there is a limit to how low AOVs can go. This has consequences for: (a) the growth of the BNPL industry; and (b) the profitability of the BNPL business model.

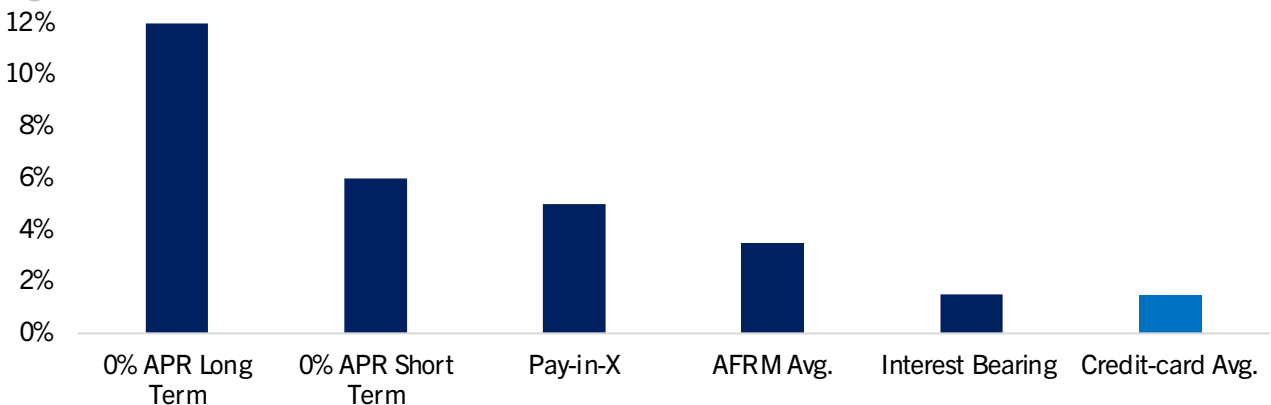
BNPL providers charge merchants c.2x the fees that credit card providers do, claiming that their products boosts basket sizes, conversion rates, and repurchase frequency (Figure 14). However, for certain low margin merchants, the increased cut that BNPL providers take from their margin relative to credit card providers makes the transaction unprofitable. Supermarkets are an example of merchants who would struggle to find the extra % necessary to pay BNPL providers. Walmart, Costco, and Dollar General all have Net Income margins below 3% and Operating margins of c.4% (90). It could quickly become uneconomical for these merchants to pay the high fees charged by BNPL providers while maintaining profitability. The consequences of this are that, AOV will likely reach a theoretical limit, with consumers only being able to use BNPL products for higher margin purchases such as fashion. This limits the TAM for BNPL players relative to their credit card counterparts. The solution for BNPL providers is to reduce the % cut they take from merchants, but then this makes the BNPL business model uneconomical for the provider. Most BNPL providers do not turn a profit (91), reducing their take-rate does not make sense for them given their uniquely high cost of funding relative to traditional credit providers. A race to the bottom on merchant fees helps none of the BNPL providers.

Transaction Frequency: We also think that there is a theoretical limit to transaction frequency. There is likely a cap on the number of repayments which an individual can manage at once before the different split-payments over different time periods become too confusing to handle. We think this also places a cap on the BNPL TAM relative to credit card providers. We do not think that consumers will come close to using BNPL products as frequently as they use their credit card.

Balance Sheet and Interest Rate Risk: Unlike traditional fintech companies, BNPL providers carry a significant amount of balance sheet risk and are reliant on the public markets to finance their loans (92). An increase in interest rates, or even an maintenance of rates at their current level - given the anticipated inflationary pressure from tariffs - may lead to a deterioration in consumer credit conditions (93). In this environment, the BNPL business model may face difficulty as providers struggle to finance their loans.

Figure 14

AFRM's vs Credit Card Merchant Fee



Regulatory Risk: While we have seen nothing to indicate looming regulatory risk on the horizon, this risk always exists for consumer-facing financial products. Increased regulation may limit growth, squeeze margins, and reduce profitability (see Industry Overview).

Outlook

We see BNPL products as an alternative to credit cards, which should grow in popularity over time due to:

- (1) Attractive unit economics which should drive profitability as BNPL providers scale;
- (2) Changing consumer preferences as Millennials and Gen-Z allocate a greater proportion of their spending away from traditional credit cards;
- (3) The structural advantages BNPL products have over traditional credit cards due to their short duration;
- (4) Increased merchant engagement, as merchant's see increased conversion rates, AOV uplifts etc.;
- (5) The business model's two-sided network effect which should create a powerful flywheel;
- (6) The underwriting expertise of BNPL providers relative to credit card competitors; and
- (7) Falling interest rates across the U.S., Europe, and the UK, which should act as a tailwind, reducing BNPL providers' funding costs and driving increased consumer adoption.

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